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Cigarette volume growth inches up: How is ITC driving sales?

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Second quarter of FY17 may bring in some good news for ITC as its cigarette volume growth is likely to continue. According to Macquarie, distributors and retailers across different geographies suggest a further pick-up in cigarette volume growth in Q2 FY17 led by 64mm category. ITC, which earns around 80 percent of company's profit, saw cigarette volumes rising in Q1 after a gap of 12 quarters.

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After a lot of struggle to manage cigarette volume growth (muted FY16), what seems to be working for ITC is its pricing. ITC has not hiked prices in last 18 months (no price increase in FY17 in 64mm and 69 mm) which has made it affordable.

Macquarie says ITC has shifted several key brands from 69mm to 64mm category. "Even though the last phase of shifting was in April 16, the full benefit of the shift will be reflected in 2Q17. The shift to 64mm for the brands at same price has made them more profitable. We believe the Street's concern on down trading to impact profitability is misplaced," it says in a note.

Few of ITC's cigarette brands are Wills Navy Cut, Gold Flake Kings, Gold Flake Premium lights, Gold Flake Super Star, Classic (Verve, Menthol, Menthol Rush, Regular, Citric Twist, Mild & Ultra Mild), 555, Silk Cut, Capstan, Berkeley, Bristol and Players.

Improvement in cigarette business is likely to ramp up its business performance in Q2. Last quarter, the cigarettes-to-hotels-FMCG major missed analysts' expectations on profit and operational front due to pressure on legal cigarette industry volume & sluggish demand in the FMCG industry.

In Q1, cigarette business which contributes 62 percent to total revenue, registered a 6.4 percent growth in revenue at Rs 8,230.6 crore on yearly basis with the earnings before interest & tax (EBIT) growing 8 percent and margin expansion of 50 basis points.

Macquarie expects revenue growth of the FMCG business to pick up significantly in second half of FY17 on improving macro and new product launches. It says paper prices are up significantly in the September 16 due to shut down of competitor plants.

With a target of Rs 304 per share it believes GST tax implications and the risk/reward is favourable at the current valuation. The stock is trading at 20x FY18 (40 percent discount to FMCG peers) but adds that double-digit cigarette EBIT growth may reduce the valuation discount.

"Our scenario analysis suggests that in the event of revenue neutral taxation in GST regime the upside in the stock can be potentially 30 percent. In the worst case assumption (current excise duty and GST rate of 40 percent), the downside is limited to 8-9 percent from the current levels," Macquarie adds.